Latest student aid? Kindness from strangers

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Online loans supplement more traditional sources

By Angel Jennings, Globe Correspondent | August 3, 2008

Credit cards. Home equity loans. Retirement accounts.

Used to be, these options were last resorts for parents paying for their children's college tuition. Now, tapping into home equity, raiding a 401(k), maxing out Visas and MasterCards, and - the latest craze - borrowing online from strangers, have become more attractive as private student loans have gotten increasingly difficult and more expensive to get.

"It's a tough time for loans," said Bill Simpson, a financial planner at Azimuth Financial Planning in New Hampshire. "People are going to drastic measures to pay for their children's education."

Parents and students are responding to the recent credit crunch, which has pushed several lenders out of the private student loan market.

The Massachusetts Educational Financing Authority on Monday said it would no longer provide private loans to 40,000 students, joining a list of more than 50 private lenders that have stopped issuing student loans this year. And the nation's largest provider of student loans cut the amount of private loans it issues to $7 billion this year, down from $8 billion a year ago.

Meanwhile, remaining lenders are imposing more stringent standards, making it difficult to get a loan and more costly for those who do qualify.

That has some students and parents scrambling to find other options to pay tuition. But financial aid analysts warn that doing things such as borrowing from 401(k)s or charging credit cards could put parents in a financial bind.

"With all the uncertainty in the economy and the job market, the wrong move could cause the parent to lose their home or pay hefty fees," said Karen Busanovich, a Woburn financial planner who specializes in student loans.

To be sure, most experts agree it's wrong to use credit cards to fund a college education. Credit card companies often jack up interest rates if users miss even one payment - sometimes even if they're late paying on another credit card - and add stiff penalties on top of that.

The terms and higher interest rates also make using plastic one of the least attractive options. Additionally, unlike traditional loans, users cannot defer payment while they are in school or take a tax break on interest paid.

"That's a dangerous game that could lead to a downward spiral," Simpson said. "If you don't have the money today, then will you really have the money tomorrow when the bill is due?"

Raiding 401(k) retirement accounts could also be a poor option, even though it might seem like the next logical choice since it is money already saved. Most financial experts strongly warn against it.

Money withdrawn from a 401(k) is often heavily taxed. Borrowers sometimes pay up to 40 percent of the amount in taxes and early withdrawal penalties.

In addition, the loan has to be paid with after-tax money, and again when the retiree cashes out, so the funds are taxed twice.

A growing alternative to using credit cards and tapping into retirement accounts is peer-to-peer lending websites. Financial experts say the sites, which facilitate strangers making loans to others, can be an alternative to raiding retirement accounts and running up credit card bills.

One benefit: The rates are comparable with those of private loans, said Mark Kantrowitz, the publisher of www.finaid.org.

"It hasn't done significant volumes," said Kantrowitz, who estimates the peer-to-peer lending sector issues in the low tens of million of dollars in student loans out of the huge $17.5 billion student loan industry.

"But it looks promising that it would grow over the next several years. It's just not the comprehensive solution to the student loan problem."

Here's how peer-to-peer lending works: In a contemporary version of borrowing from your neighbor, peer-to-peer lenders allow people to list the amount they wish to borrow on the website and the maximum interest rate they are willing to pay. Then, other people agree to lend the money and list the interest rate they plan to charge.

The loans can be attractive because they can be easier to obtain than traditional bank loans. Most peer-to-peer lenders do not use the applicants' FICO score. Instead, sites that handle student loans often use their own scale based on the applicant's academic characteristics, such as their standing in college, grade point average, course of study, and the profile of the educational institution.

One downside to peer-to-peer lending is that the loans often are given piecemeal. Usually lenders offer only a fraction of the total amount of the loan requested, which means borrowers may wind up owing several lenders at a time.

At peer-to-peer lender Fynanz (pronounced finance), based in New York , borrowers can get up to $40,000 a school year at a negotiable rate. But the company says that since its March launch, the largest loan it has funded was for $7,900.

The site is gaining popularity: Fynanz said the number of applications for student loans jumped to 102 on Monday after MEFA's announcement. A week earlier, the company received only 60 applications.

Yasifur Rahman, who pays his brother's way at Queens College in New York, recently requested a $2,600 loan on Fynanz so he could help his brother with tuition and buy him a new laptop. He received small loans from about 10 people, some only lending him $50. The average interest rate was 6 percent.

"Normally I would have took out a small loan or put it on my credit card," said the Queens resident. "But this was a better deal."

Some parents may also think they're getting a deal by taking out a home equity line of credit to pay tuition. Homeowners have long relied on home equity loans to fund major financial purchases, so it's no surprise that parents are looking into them now, said Busanovich, the Woburn planner.

On the surface, home equity loans certainly seem like a great option: They have rates comparable with private loans and easy terms. But just like private loans, they are also less available. The shakeup in the housing market has caused home prices to go down, which means parents might not have enough equity in their home to borrow against. Or worse, if they do get a home equity loan, parents risk losing their homes.

"Parents think they need to sacrifice for their kids," said Simpson, the New Hampshire planner. "But they need to think about themselves."

Meanwhile, Busanovich said parents and students rarely explore one important alternative to private student loans - one that can ease the financial burden of college tuition.

"It doesn't have to be a $40,000-a-year school," she said. "There are good schools that cost less than private. And those are much better options."

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